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TAGS: ECIN ECON EFIN EUN PREL
SUBJECT: DEMARCHE TO EU MEMBER STATES ON EFFECTS OF THE
FINANCIAL CRISIS IN CENTRAL AND EASTERN EUROPE

Classified By: EUR PDAS MARCIE RIES FOR REASONS 1.4 (b) and (d)

¶1. (U) This is an action message, see paragraph 7.

SUMMARY

¶2. (C) The effects of the global financial and economic crisis have been acutely felt in many Central and Eastern European countries. Of the eleven countries that have sought IMF Stand-By Arrangements since the start of the global economic crisis, eight are in Europe - Georgia, Ukraine, Hungary, Iceland, Latvia, Serbia, Belarus, and Armenia. The crisis has prompted protests and riots across the region and prompted the collapse of at least two European governments. As economic and financial conditions worsen both regionally and globally, further political instability may be expected, including a rise in extremism, xenophobia and populism. A sharp deterioration in one or more of these countries could spark a severe banking crisis in Europe given the level of many Western European banks' exposure to these markets. As EU member states consider steps to stabilize the wavering economies of member states, as well as EU aspirants, and non-members, U.S. agencies request that posts stress the importance of continued EU engagement with emerging European economies through a demarche to member state officials. This message was underscored by Treasury Secretary Geithner on March 11, when he called on G-20 countries, working with the international financial institutions (IFIs), to mobilize substantial resources that can be deployed quickly and in innovative ways to help emerging market economies restore growth and begin recovery. END SUMMARY.

BACKGROUND

¶3. (C) The global financial and economic crisis originated in financial institutions in the United States and Western Europe, but subsequently hit the emerging market economies in Eastern and Central Europe, where the impact has been deeper and broader. The unfolding crisis may threaten the great strides former East Bloc countries have made in reforming their economies, attracting large capital inflows from the West, and achieving several years of high growth. Now, the deepening economic and financial crisis has reversed these capital flows, exposing Central and Eastern Europe's largely foreign-financed banking sectors and sharply curbing demand for its manufactured goods. As a result, some countries in emerging Europe now face fiscal deficits ranging from 4-8% of GDP, external debt obligations amounting to several times their official reserves, and double-digit current account deficits. Financing these deficits is a huge challenge given the sharp drop in capital flows and the countries' inability to access capital markets because of perceived increased economic risks.

¶4. (C) Each country in the region has its own individual monetary, fiscal and economic weaknesses and strengths. However, large external financing gaps and severely impaired market access to capital have driven down some currencies by

15 - 20% against the euro, with other countries experiencing large declines in official foreign currency reserves. The crisis has exposed vulnerabilities in the region's largely Western European-owned banking systems with high levels of foreign currency lending which, given local currencies' depreciation against the euro, is weakening bank balance sheets, increasing the possibility of large losses for financial institutions and creating genuine financial hardships for many households and companies. The developments have particularly negative implications for Western Europe because of Austrian, Swedish, Italian, Greek and German banks' significant exposure to the region. European banks have over $1.4 trillion in exposure to Central and Eastern Europe (including Russia); in comparison U.S. bank exposure is about $56 billion.

¶5. (C) Some countries have already accessed EU and International Monetary Fund (IMF) support (Hungary, Latvia, Ukraine, Armenia, and Serbia); others will likely need official sector assistance (Lithuania, Croatia, Montenegro, Romania and Bulgaria). In their February 22 G-20 preparatory meeting in Berlin, EU leaders proposed doubling IMF resources to $500 billion to help deal with the current crisis as well as to assist eurozone countries that may also need financial support. While leaders focus on increasing IMF resources, EU member states also need to undertake prompt, coordinated action to address Emerging Europe's economic and financial

crisis. An early, proactive regional solution could minimize EU taxpayer liabilities down the road and send financial markets a strong signal of the EU's intention to address regional banking and fiscal challenges. A clear first step would be to increase the EU's euro 25 billion balance of payments facility that is co-financing programs in Europe with the IMF.

¶6. (SBU) On March 11, Treasury Secretary Geithner announced U.S. approaches within the context of the G-20 to address the challenges faced by many emerging market economies. Secretary Geithner called on the G-20 to support substantially increasing emergency IMF resources through a significant expansion of the New Arrangements to Borrow (NAB). The NAB could be increased by up to $500 billion and its membership could be enlarged to include more G-20 countries. He called on the World Bank and other Multilateral Development Banks to more effectively leverage existing resources by flexible use of their balance sheets to help meet financing needs. The additional resources should be targeted to help emerging market and developing countries restore growth, embark on recovery, and expand trade. Secretary Geithner also supported bringing together bilateral and multilateral institutions, including export credit agencies and multilateral development banks, to use their substantial resources to attack risk and liquidity barriers to the flow of trade finance.

¶7. (SBU) To encourage effective and timely EU support for Emerging Europe, Washington agencies request that action addressees approach EU member state governments to express our commitment to work with international partners to help countries weather these shocks and to urge EU members to create additional effective mechanisms to address financial vulnerabilities in Europe. Addressees should deliver the points below verbally to finance ministries at the highest appropriate level including finance ministers, as well as to foreign ministries and to the offices of the head of government, as appropriate.

¶8. (SBU) TALKING POINTS:

- We are concerned about the increasing difficulties that the global economic and financial turmoil is causing in Central and Eastern Europe, both in European Union member states and others in the region.

- Failure to begin to address the vulnerabilities in Central and Eastern Europe has serious risks for European banks, EU Member States, and ultimately the global financial system. We must all work together to stem the economic and financial crisis in the region and solidify the economic and social gains made in the past 18 years of transition and integration.

Working with International Partners

- Protectionism, nationalism, and 'beggar thy neighbor' policies such as: guaranteeing home banks' deposits only; subsidizing only a firm's domestic production; or setting conditions on home banks to cut back on lending in foreign subsidiaries to maintain overall capital adequacy are harmful.

- Some countries have undertaken meaningful stimulus packages, while others have room to do more. These actions are critical to support domestic demand. Each of us needs to do as much as we possibly can and commit to further action as necessary to spur growth.

- Stimulus efforts must be applied in a manner consistent with obligations under international trade agreements.

Address Vulnerabilities in Central and Eastern Europe
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- The impact across the region is varied, but for those countries requiring assistance, it is important that they address problems early from the IMF and other multilateral organizations in order to limit the long-term costs.

- The U.S. is committed to working with our international partners to help these countries address the economic and financial shocks they face.

- The measures the IMF and other IFIs are proposing are part of the solutions and we endorse pro-active crisis responses in these institutions.

- But the problem in Central and Eastern Europe demands more in terms of finding creative, flexible and rapid response mechanisms at an EU or regional level or, in some cases,

bilaterally.

- Western European banks have the greatest exposure in the region - over $1.4 trillion - and the impacts of the crisis will be most strongly felt by European banks and countries. While the impacts vary across countries, all of Europe could be seriously affected if strong measures are not forthcoming quickly.

- We urge European governments to exercise leadership. Europe needs to urgently consider flexible approaches, through European instruments as well as existing IFIs, to provide financing and confidence building measures.

Support U.S. G-20 Initiatives for Emerging Economies
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- On March 11, Treasury Secretary Geithner called on G-20 countries, working with the international financial institutions, to mobilize substantial resources that can be deployed quickly and in innovative ways to help emerging market economies restore growth and begin recovery.

- We hope you will support U.S. efforts in the G-20 to substantially increase emergency IMF resources through expansion of the New Arrangements to Borrow (NAB). The NAB could be increased by up to $500 billion and its membership could be enlarged to include more G-20 countries.

- We are calling on the World Bank and other Multilateral Development Banks to more effectively leverage existing resources by flexible use of their balance sheets to help meet financing needs. The additional resources could be targeted to help emerging market and developing countries restore growth, embark on recover, and expand trade.

- We also support bringing together bilateral and multilateral institutions, including export credit agencies and multilateral development banks, to use their substantial resources to attack risk and liquidity barriers to the flow of trade finance.

Support for the European Neighborhood

- National regulators' rescue efforts for failing banks that focus on saving only the headquarters while leaving out Central and Eastern European subsidiaries could have catastrophic consequences.

- Expanding EU assistance beyond the 25 billion euro Balance of Payments facility and exploring options to assist non-EU countries seem to be important first steps.

- Other measures, including revisiting euro adoption procedures and requirements may also be needed for particular countries.

EU Action

- While plans have been announced, the EU does not appear to act resolutely enough. News of the EU's inaction at the March 1 Summit disappointed markets, and led to a further sell-off.

- The EU needs to proactively address this crisis.

For Berlin only:

- We were pleased to see Chancellor Merkel's February 26 statement and hope Germany can follow through quickly with additional actions.

For Budapest, Vienna, and Stockholm:

- We understand that you share our concerns and are voicing similar sentiments within the EU, how can we help you?

For London and Paris:

- There is a risk that while the G-20 focuses on the technical issues surrounding the global financial architecture in the lead-up to the April 2 Summit, we will miss the ability to act quickly to avert a crisis.

End talking points.
CLINTON